Pigeon Telephone Company

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August 27, 1992

Ms. Donna R. Searcy
Secretary
Federal Communications Commission
1919 M Street, NW - Room 222
Washington, D.C. 20554

RE: CC Docket No. 92-135: Comments on the Notice of Proposed Rule Making (NPRM), FCC 92-258, released July 17, 1992

Dear Ms. Searcy:

Please find enclosed for filing the original and ten copies of comments from the Independent Telephone Access Group (ITAG) related to Docket No. 92-135. We would appreciate your acknowledging receipt of these items by returning a time-stamped duplicate of this letter in the enclosed self-addressed stamped envelope.

Thank you for your assistance.

Cordially,

Edwin H. Eichler
President

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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation	)))))	CC Docket No. 92-135

Comments of the Independent Telephone Access Group

The Independent Telephone Access Group (ITAG)[1] hereby provides its comments on the Commission's Notice of Proposed Rule Making (NPRM), FCC 92-258, released July 17, 1992.

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I. Introduction and Overview

The NPRM advances three proposals to implement regulatory reform for the interstate services of small and mid-sized LECs subject to rate of return regulation. These proposals are characterized by the Commission as representing "a continuum of increasingly incentive-based approaches that permit companies to choose a plan which best fits their circumstances."[2] The trade-off, in comparison to existing rate of return regulation, is that in return for assuming greater risks, carriers would have the opportunity to achieve higher earnings and reduce their administrative burdens. The three proposals advanced by the Commission are:

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1 The ITAG consists of 12 small and medium-sized independent telephone companies from all sections of the United States. The members of ITAG are The Champaign Telephone Company, Urbana, Ohio; The Chillicothe Telephone Company, Chillicothe, Ohio; Chouteau Telephone Company, Chouteau, Oklahoma; Granite State Telephone, Inc., South Weare, New Hampshire; Mashell Telephone Company, Inc., Eatonville, Washington; Merrimack County Telephone, Contoocook, New Hampshire; Millry Telephone Company, Inc., Millry, Alabama; Northern Arkansas Telephone Company, Inc., Flippin, Arkansas; Pigeon Telephone Company, Pigeon, Michigan; Totah Telephone Company, Inc., Ochelata, Oklahoma; Waitsfield-Fayston Telephone Company, Inc., Waitsfield, Vermont; Western New Mexico Telephone Company, Inc., Silver City, New Mexico.

2 NPRM, paragraph three.

- An optional incentive plan for rate of return carriers which is intended to serve as an intermediate step towards price caps.

- Expansion of the 61.39 rules for small companies to permit these carriers to use historical cost-based filings for common line as well as traffic-sensitive rates.

- A streamlining of baseline rate of return regulation.

In the ITAG's view, the Commission's proposals, however well intended, would not meet our companies needs to maintain some measure of revenue stability in an era of rapidly changing technological requirements, increasingly sophisticated customer demands, and heightened regulatory scrutiny by the states. As such, the trade-off between the risks and rewards of operating under the Commission's proposals is simply not attractive enough that any of the ITAG companies would be likely to choose to operate under any of these options as currently constituted. Consequently, while the availability of these options, so long as they remain merely optional, may be relatively benign, the ITAG believes that the Commission may be placing itself in the position (similar to the $.35 surcharge to fund CCL volume discounts) of giving a party to which nobody comes. However, with some adjustments, these proposals, especially the expansion of the small-company tariff filing rules to common line rates, could provide viable alternatives to existing forms of regulation that meet Commission, customer, and industry needs.

In the remainder of these comments, the ITAG will address the following issues:

- Incentive regulation would not necessarily enable small and mid-sized LECs to continue responding to changing industry technological, market, and regulatory conditions.

- The Commission's optional incentive regulation proposal, as currently constituted, would not be an attractive alternative to current rate of return regulation without considerable modification.

- The Commission's proposal to extend the Section 61.39 Small Company Filing Option to common line could be adopted but with a demand growth formula that shares the benefits of demand growth between LECs and IXCs.

- Any restructuring of baseline rate of return regulation or NECA settlement procedures must remain optional.

In summary, while the ITAG commends the Commission's effort to make incentive forms of regulation available to those carriers who choose to adopt it, there are likely to be few "adopters" unless significant modifications are made. Further, rapidly changing industry conditions and the resulting impact on cost characteristics are unlikely to enable many small and mid-sized LECs to operate successfully under any form of incentive regulation. Consequently, if adopted, these proposals must remain options, and not requirements, for the foreseeable future.

II. Technological, Market and Regulatory Developments in the Operating Conditions Facing Small and Mid-Sized LECs Are Not Compatible with the Adoption of Incentive Regulation

Incentive regulation, as a general proposition, is based on the premise that, in return for the rewards of potentially higher earnings and reduced administrative burdens, regulated carriers will achieve cost-reducing efficiencies, which ultimately will result in lower customer rates than would have been achieved under traditional rate of return regulation. These benefits will only be achieved, however, if the anticipated cost savings can be realized and demand grows at stable or above-normal rates. In the absence of these conditions, companies are likely to be consistently unable to achieve their authorized rate of return, unless frequent midcourse rate corrections are permitted.

In a variety of areas, the operating conditions facing small and mid-sized LECs over the next few years are unlikely to provide an environment in which the conditions for successful implementation of incentive regulation are satisfied. Most importantly, a number of technological, market, and regulatory forces are likely to drive up small and mid-sized LECs' costs over the next few years—forces which are largely outside the LECs' control and unlikely to be counterbalanced by any above-normal demand growth or traditional cost-cutting measures. Among the uncontrollable factors likely to increase small and mid-sized LECs costs over the next few years are:

- Implementation of 800 Database and SS7 services.
- Implementation of equal access, with the potential for premature switch replacement (to, for example, avoid double tandeming of interexchange traffic).
- Implementation of revisions to the North American Numbering Plan.
- Customer requirements for routing diversity.
- State-required expansion of EAS areas.
- Implementation of universal one-party service, combined with the elimination of mileage charges.

- Customer demands for more sophisticated and enhanced services, requiring software or switch upgrades.

- Ever-increasing regulatory requirements, particularly at the state level, such as quality of service reporting, more intensive scrutiny of earnings levels, and increased use of statewide rulemaking proceedings with mandatory participation.

Although some of these items are more the result of state PSC actions than those of this Commission, the operation of the Part 36 separations procedures in many instances assigns portions of these increased costs to interstate as well. On the other hand, most of the required network upgrades, such as those related to SS7, 800 Database, and the North American Numbering Plan revisions, are principally undertaken to meet national/interstate needs. In either case, the resulting cost increases will be real, unavoidable, and potentially unrecoverable from the cost causer under an incentive regulation plan.

Although the future demand growth is not as predictable as future cost increases, nevertheless several factors indicate that projecting historic demand patterns over future periods may not reflect actual demand levels in the future. These factors are:

- Stable, rather than declining, IXC prices, as the IXCs shift their focus from gaining market share to increasing profitability.

- Increased competition from alternative local service providers and access bypass arrangements, such as VSATs, cellular, PCS, cable companies, and, in suburban areas, CAPs.

- Potential to lose traffic of a very large customer to IXC-initiated or other bypass arrangements, especially as the interconnection requirements proposed in CC Docket No. 91-141 are implemented.

As a result of these concerns, while the ITAG believes that an appropriately designed incentive regulation plan should be made available to those carriers that wish to participate in such a plan, under no circumstances should such a plan be made mandatory. The likely result would be persistent carrier underearnings, resulting in frequent requests for midcourse corrections, thereby diluting any reduction in administrative burdens.

III. The Commission's Optional Incentive Regulation Plan Fails to Appropriately Balance Risks and Rewards and Must Be Modified to Present an Attraction for LECs

Although the ITAG companies, due to the factors described in the previous section, would be unlikely to adopt any optional incentive regulation plan this time, we believe that, with some modifications, the FCC's optional incentive regulation plan structure could provide an attractive option if industry environmental and operating conditions stabilize in the future. In this section, we will briefly note the types of modifications that would enhance the viability of the Commission's plan. Among the modifications we would suggest be made are:

- Expand the earning zone to 200 basis points above and 100 basis points below the authorized rate of return. The opportunity to earn a mere 75 basis points over the existing authorized rate of return, including the 25 basis point buffer zone, with full refund for earnings above that level, when combined with the risks confronting small and mid-sized LECs, does not provide a sufficient economic incentive to elect such a plan.

- Some alternatives to the "rate charged by the nearest price cap LEC" criterion for new services should be permitted. If the rate charged by the nearest price cap LEC would not cover a company's cost of offering a new service, it would simply not offer the service. The presentation of cost studies based on embedded or current cost should be permitted and routinely approved in requests to provide new interstate services.

- The requirement that carriers electing the optional incentive regulation plan file quarterly service quality reports is sufficiently onerous to discourage participation in the plan. Making such reports annual, or accepting state PSC-required reports in lieu of a separate federal report, could mitigate this problem while, nevertheless, achieving the Commission's objectives.

- In contrast to the price cap plan, the requirement that carriers retarget their rates at the authorized rate of return every two-years only permits carriers to retain any efficiencies achieved for the two-year period, at which time the benefits would be entirely recaptured by ratepayers. If this plan is to provide an attractive alternative to price caps for carriers interested in incentive regulation plans, some mechanism must be developed to enable carriers to retain the benefits of their efficiency gains for some reasonable period in order to provide incentives to achieve additional gains.

- The Commission's requirement that companies electing the incentive plan do so for both common line and traffic-sensitive rates is both unnecessary and a deterrent to adoption of the plan. Because many carriers have unavoidably high loop costs and rely on long-term support payments to maintain their CCL rates at reasonable levels, full incentive regulation would not be a viable option, even if appropriate for traffic-sensitive services, for these carriers.

- Companies should not be required to file tariffs under Section 61.38 of the Commission's rules if they drop out of the optional incentive regulation plan. Filing a Section 61.39 tariff or returning to the NECA pool should also be available to carriers dropping out of the incentive plan.

Adoption of these modifications to the Commission's optional incentive regulation plan would go a long way to providing real incentives to LECs, thereby increasing the likelihood that LECs would choose to participate.

IV. The Demand Growth Adjustment Proposed for Common Line Tariffs Under the 61.39 Rules Does Not Reflect an Appropriate Sharing of Growth-Based Benefits Between IXCs and LECs

The ITAG fully supports the Commission's proposal to extend the Section 61.39 small-company tariff filing provisions to common line rates. Nevertheless, we believe that the Commission's proposed growth adjustment for common line demand inappropriately assigns all the benefits of demand growth to IXCs and none to the LECs. In particular, the demand growth adjustment proposed is considerably more restrictive than that imposed on price cap companies, for whom a sharing of the benefits of demand-related growth is provided. Similar to the adjustments to CCL demand made in the price cap plan, a demand growth formula should be developed which adjusts for changes in common line costs per access line and shares the benefits of demand growth between LECs and access customers. To achieve a result comparable to that imposed on price cap carriers, the ITAG suggests that the following would represent an appropriate formula for sharing the benefits of common line demand growth:

$$CCL_{Proj} = CCL_{Hist} * (1 + g/2)$$

Where

CCL_{Proj} = Forecast CCL demand for the next tariff period

CCL_{Hist} = CCL demand, in MOU, over the base period

g = MOU per access line during base period over MOU per access line over previous base period

CCL rates would then be developed as follows:

$$CCL_{Rate} = \frac{Cost_{Hist} * (1+ CF\text{-}X)}{CCL_{Proj}}$$

Where

$Cost_{Hist}$ = Revenue requirement over base period

CF = Cost adjustment Factor for CL costs over base period (could use CPI or telephone-specific index)

X = Productivity factor for base period (could be 0 to 0.01, as determined by Commission)

A formula similar to the above both incorporates a sharing of the benefits of demand growth between access customers and LECs and reflects the fact that common line costs will grow over time. The ITAG believes that considerable attention should be paid to an appropriate cost adjustment factor in establishing common line rates under the expanded 61.39 and optional incentive regulation plan proposals. For example, the CF could be based on CPI, similar to the price cap plan, or some historical trend of common line cost growth, if a CPI-based index is deemed inappropriate. The X productivity factor should be set considerably lower than that established for price cap companies due to the lack of scale and scope economies experienced by small to mid-sized companies and could be established at levels between 0 and 1.0 percent. Use of a cost growth factor, adjusted for productivity gains, would make the approach under the expanded 61.39 and optional incentive regulation plans more comparable to the incentives available under price cap regulation.

V. Any Adjustment to Baseline Rate of Return Regulation for NECA Participants and Section 61.38 Filing Carriers Should Be Optional

Similar to the ITAG position with regard to other elements of the NPRM, the ITAG believes that the Commission's proposed restructure of the baseline rate of return regulations may be appropriate for some carriers but should remain optional in all cases. In particular, the proposed modifications to baseline rate of return regulation should not be imposed on the NECA unless that organization requests to be so regulated. As was noted in a previous section, the small and mid-sized LECs that participate in the NECA pools are likely to face significant and uncontrollable cost increases over the next several years. Unless the NECA can incorporate the effects of these cost increases in its respective tariff filings, the NECA pools will inevitably experience a return shortfall. If the results of these reforms of baseline ROR regulation were to generate persistent earnings shortfalls for the NECA pools, and the NECA member companies, such a posture would likely not meet the constitutional confiscation-of-property test. Similarly, any incentive incorporated into NECA's settlements process, such as carriers committing to a fixed level of settlements for a specific period based on historical results, must remain optional to ensure reasonable levels of cost recovery in a changing operating environment. The failure to allow tariffs to be filed upon reasonable projections of LEC costs would likely, as noted above, result in frequent LEC requests for midcourse tariff filings, with the attendant administrative burdens. Simple extrapolations of historical costs or reliance on historical costs is unlikely to produce rates reflective of future costs in the current telecommunications environment.

VI. Conclusion

The ITAG's principal concern in this proceeding is to ensure that the adoption of any alternative incentive regulation plan remains optional for small and mid-sized LECs. Generally, we do not believe that likely near-term cost or demand trends will render incentive regulation viable for our companies. Without the ability to adjust for future cost and demand changes, there is a considerable likelihood that the ITAG members would not be able to achieve their authorized interstate rate of return. We have provided suggestions for enhancing the proposals advanced by the Commission in order to ensure that they do provide appropriate incentives to LECs.

We hope that these comments assist the Commission in defining the range of issues which must be considered in implementing incentive regulation plans and indicate why mandatory implementation of such plans would be inappropriate both now and in the future.